INTERNATIONAL REGULATORY STRATEGY GROUP RESPONSE TO THE EUROPEAN COMMISSION'S CONSULTATION ON THE EU CORPORATE GOVERNANCE FRAMEWORK

The International Regulatory Strategy Group (IRSG) of the City of London is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to contribute to the shaping of the international regulatory regime, at global, regional and national levels, so that it promotes open, competitive and fair capital markets globally, supporting sustainable economic growth. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views. It is an advisory body both to the City of London Corporation, and to TheCityUK, a new independent practitioner-led body which has been established to coordinate the promotion of the UK-based financial services industry.

The European Commission's Green Paper on the EU Corporate Governance Framework

The IRSG welcomes the initiative the Commission has taken in reviewing the framework for corporate governance across the EU. Effective governance regimes are essential to well functioning capital markets which can fund growth and investment competitively. They provide confidence to investors and help ensure companies are run in the interests of their shareholders. They will therefore have an important role to play in post-crisis European economies, supporting growth and economic recovery.

The financial crisis necessarily precipitated a re-examination of governance structures and the extent to which they remained appropriate and fit for purpose. In the UK, the opportunity was taken not just to focus on governance within financial institutions but also within other listed companies. This led to revision of the UK Corporate Governance Code and the introduction of the UK Stewardship Code which has the objective of improving the quality of engagement between institutional investors and companies. The IRSG believes that the two UK Codes, regulated by the Financial Reporting Council (FRC) and enforced by a flexible comply or explain approach, encourage high standards of governance behaviour. Key to this, and which is core to the FRC's approach, is developing within UK business a commitment to following the spirit as well as the letter of the Codes.

The IRSG understands the decision by the Commission to focus specifically on corporate governance in financial institutions in its Green Paper of June 2010. Whilst failures of governance were not, of themselves, solely responsible for the financial crisis, there is no doubt that, for example, a lack of sufficient risk oversight by boards and proactive engagement by shareholders were contributory factors. There was also a pervading culture of short-termism which impacted on the mobility and efficient allocation of capital. The stimulation of a more long term approach is crucial to economic competitiveness and healthy capital markets.

The current Green Paper rightly recognises the distinction between governance in financial institutions and those in listed companies more generally and that outcomes proposed as a consequence of the June 2010 Green Paper may not be wholly relevant elsewhere. The IRSG agrees with the Commission that it's focus on the core issues of boards, shareholders and comply or explain and the generic question of how far the size of companies should determine the application of corporate governance rules is most appropriate in developing a debate on appropriate future governance regimes.

In its response the IRSG focuses on the key strategic issues in each of these areas raised by the Commission in the questions to which it has requested response. We would also like to make the following statements of principle which underpin our more detailed response

- We strongly support a corporate governance framework for the EU which is underpinned by national codes and comply or explain regimes which are underpinned by statute. We believe that such regimes are capable of securing higher levels of compliance than detailed and proscriptive legislation. It is however crucial that comply or explain regimes re genuinely effective and agree that there would be value in further work to identify, for example, how the quality of explanations might be improved.

- We agree with the Commission about the role of boards and the scope for corporate governance regimes to provide checks and balances on boards' operations including the enhancement of skill sets and diversity and the breakdown of group think. We do not however believe that this can most effectively be achieved by the imposition at EU level of, for example, mandatory quotas. These would be entirely arbitrary and would be unable to take account of the specificity of individual circumstances. We strongly recommend to the Commission the approach adopted in the UK through the Corporate Governance Code and the Davies Report on women in boards.

<u>General Questions</u>

It is right that the Commission should raise the issue of how and if corporate governance regimes might apply to listed and unlisted companies including SMEs. The Commission also recognises that principles for listed companies could not simply be transposed to unlisted companies as the challenges they face are very different. Given the differences in listing requirements, company structures etc. across Member States, we would strongly caution against any move towards an EU level approach and argue that these are matters which are best resolved at national level through codes and guidance. There could however be a role for sharing best practice among Member States which would be helpful to those who have not yet, for example, considered the scope of any guidance to unlisted companies.

<u>Boards of Directors</u>

The key challenge is to secure a balance between higher quality and better performing boards and maintaining a degree of flexibility in how boards operate to enable them to respond effectively and in a timely way to, for example, business or economic crises.

It is a principle of the UK Corporate Governance Code that there should be a clear division between the responsibilities of the Chair and of the chief executive (**Question 3**). There is however also a provision that if, in exceptional circumstances, the board considers that the roles should be combined, major shareholders should be consulted in advance and the reasons set out at the time of appointment and in the next annual report. The IRSG believes that this is the right approach which provides sufficient checks and balances to ensure that the presumption against combining the roles remains paramount. However it is also right that there should be flexibility to enable the roles to be combined when, exceptionally, it is in the company's and shareholders' interests to do so. Often such action would have to be taken at very short notice and where delay might be damaging. The IRSG would therefore argue against a regime that did not provide sufficiently for such flexibility through the introduction of overly bureaucratic and time intensive safeguards.

Similarly the UK Corporate Governance Code sets out clear principles about appointments to boards to ensure that boards maintain the right balance of skills, independence, experience and knowledge and have due regard to the benefits of diversity. We believe that these fully reflect the Commission's concern to ensure that board composition fully meets the needs of a company's business (**Question 4**). We believe however that it would be most appropriate for such criteria to be set at national level through Member States' own corporate governance codes as there may be circumstances e.g. in how boards are structured which would require differing approaches to secure the same objective.

The issue of diversity (**Questions 5 and 6**) is complex. We believe that a balance needs to be struck between the objective, which we fully support, of boards maximising the benefits of greater diversity in board composition and how this can most effectively be achieved. It is clear, for example, that more diversity should help to break down over reliance on group think on boards and improve the challenge and quality of debate. This was recognised in the February 2011 report to the British Government by Lord Mervyn Davies on the role of women in boards. This recognised that companies with a strong female representation at board and top management level performed better than those without and that gender-diverse boards had a positive impact on performance. The report concluded that the business case for gender diversity on boards had four dimensions: it improved business performance, it gave access to the widest talent pool, it enabled companies to be more responsive to the market and it helped achieve better corporate governance.

These are powerful arguments with which we concur. We also support the recommendations Lord Davies made in his report including that all Chairmen of FTSE 350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015 and that FTSE 100 boards should aim for a minimum of 25% female representation by 2015, that quoted companies should be required to disclose each year the proportion of women on the board, women in senior executive positions and female employees in the whole organisation and that the Financial Reporting Council should amend the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity, including measurable objectives for implementing the policy, and disclose annually a summary of the policy and the progress made in achieving the objectives. (This fully reflects the objectives of **Question 5** and is something on which the FRC is currently consulting.)

The most contentious issue in this debate is how higher levels of board diversity can be best achieved. Lord Davies concluded that the balance of advantage lay in companies taking voluntary action to bring about change. He consciously chose not to recommend quotas taking the view that board appointments should be made on the basis of business needs, skills and ability. However a more focused business-led approach can increase the number of women on company boards at a much faster rate than in the past. We believe that this is the right approach and that the right balance of skills, independence and diversity can be achieved through effectively monitored voluntary rather than quota based systems. It is of note that a study recently undertaken by Cranfield School of Management found that FTSE 100 companies have recruited 23 women to their boards so far in 2011 (only 18 were appointed for the whole of 2010), representing 30% of board appointments and the number of blue chip companies without a woman on their boards has fallen to 14 from 21 in December 2010. Cranfield has concluded that these changes are almost entirely down to the impact of the Davies report. Also the debate on diversity often focuses on gender balance to the virtual exclusion of those others factors including skills, experience and background which can contribute to a truly diverse board and which could not be achieved through mandated quotas.

We would similarly argue against formal limits for the number of mandates any non-executive director may hold (**Question 7**). Clearly it is right that board members should have sufficient time and capacity to enable them to fulfil their roles and responsibilities to maximum effectiveness. This is reflected in the UK Corporate Governance Code which places the onus upon non-executive directors to state that they will have sufficient time to meet what is expected of them and on the board to make clear the time commitment required of non-executive directors. We believe this is the right approach. The number of mandates held is not, of itself, indicative of the ability of an individual to take on additional commitments. What are more important are the demands of individual mandates e.g. depending upon the size and complexity of the companies, two mandates could be more time intensive than four. Also any recommendation that individuals should be restricted to a specific number of mandates could become a bargaining counter in political negotiations and unlikely to result in an optimum outcome.

We strongly support (**Question 8**) the case for regular external evaluation of boards, in line with the provision of the UK Code that evaluation of the Board of FTSE 350 companies should be externally facilitated at least every three years. We believe that professional evaluation can make an important contribution in raising the performance of boards. We would, however, caution against making such evaluation mandatory for all boards, at least initially. We understand that, should such a requirement be imposed on all listed companies, there could be a shortage of sufficiently competent external evaluators to undertake this work. We recommend therefore that, subject to regular review, such evaluation should be restricted in the first instance to larger and more significant companies.

We offer no comment on **Questions 9 and 10** (remuneration) which are consistent with UK practice.

We would agree with the general presumptions in **Questions 11 and 12** relating to risk and the management of risk. We believe it is the responsibility of the board to determine a company's risk appetite and to ensure that proper and effective risk management systems and internal controls are in place. However we are unclear about the intent behind the reference in **Question 11** to 'societal risks'. As the Green Paper makes clear, wider external risks e.g. relating to the environment, human rights and health and safety are regularly subject to specific legislation and monitoring. We therefore conclude that nothing additional is needed here. If the reference to societal risks is intended to cover those matters which ordinarily come within the ambit of a company's corporate social responsibility activity, we would argue that these are best dealt with within the context of specific CSR reports. An additional caveat would be that any activity in respect of risk management and control should not move, for example, in the direction of Section 404 of the Sarbanes-Oxley Act which it is generally recognised had little impact on the financial crisis in the US and can encourage a box ticking approach.

<u>Shareholders</u>

The IRSG notes the request (**Question 13**) for examples where any current EU rules may contribute to short-termism. We welcome this open-minded approach by the Commission.. This is an important issue and reflects the unintended consequences which can flow from rules drafted to deal with specific issues without taking full account of their possible wider impact. The overriding objective should be the promotion of strong capital markets and we hope that the Commission would be prepared to take necessary corrective action where this is impaired by existing regulation.

In response to the other questions raised in respect of shareholders we would make the following comments:

- As a matter of principle we strongly support the model of shareholder control. Shareholders play a pivotal role in raising new capital which is particularly important when, for example, access to bank credit is more restricted. We believe that the action taken in the UK e.g. through Sir David Walker's Report and the introduction of the UK Stewardship Code has been pivotal in enhancing shareholder behaviour.

- Subject to more detailed work, there may be a case for greater transparency in respect of the incentive structures for and the strategies etc pursued by asset managers (**Questions 14 and 15**). However this should not lead to action which could, in practice, effectively impose investment strategies on asset managers and restrict their ability to operate in their clients' best interests.

- We strongly believe that matters such as shareholder cooperation and employee share ownership (**Questions 17 and 23**) should be matters of national competence, reflecting the different shareholder structures and legislation which apply at national levels. However if current EU law is being interpreted in a way that limits collective engagement, the situation should be clarified.

- Whilst there may be a case (**Questions 18 and 19**) for encouraging greater transparency around the role and operations of proxy advisors, any action would need to ensure that it did not distort the balance between boards and shareholders including institutional investors.

- Company structures within the UK where very few have block shareholders mean that domestically concerns for the rights of minority shareholders rarely arise (**Questions 21 and 22)**. However we are aware that this is a significant issue in some other markets and which can affect the appetite to invest by UK institutional investors in those markets. We would therefore support the principle of investigating this issue in more detail to determine whether there is a case for specific action.

<u>Monitoring and Implementation of Corporate Governance Codes</u>

Comply or explain frameworks underpin corporate governance structures within the EU. The IRSG believes that in general these frameworks have worked well and should continue to form the basis for corporate governance going forward. However this does not mean that comply or explain regimes are not capable of strengthening or improvement. The Green Paper rightly highlights often insufficient explanations for derogation from corporate governance code recommendations but also recognises that in many Member States there have been slow but gradual improvements.

We agree that if there are clear breaches of corporate governance codes mechanisms should be in place to ensure appropriate enforcement. There is also scope for doing more to improve the quality and consistency of explanations following derogations. However we would caution against an overly bureaucratic approach which could be time consuming and costly. It could also encourage a rigidity which would undermine the flexibility inherent in comply or explain and the importance of the specific circumstances of individual cases. A first step might be to put in hand further work involving national monitoring and industry bodies to identify those features which should be common to explanations and to develop proposals for how these might most effectively be implemented. Comply or explain is the bedrock on which corporate governance in the EU is based and should continue to be so. This means that we fully agree with the Commission that there is scope for improvement in how it operates but any action to strengthen comply or explain regimes should not be precipitate, should follow detailed analysis of the issues and should be based on consensus.

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